Internal Revenue Service

# memorandum

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Br4:GBFleming

date: JAN 03 1989

to: District Counsel, Chicago MW:CHI
Attention: Ms. Diane Berkowitz

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This responds to your memorandum of September 29, 1988, requesting assistance regarding the above-referenced case, which is one of several docketed cases involving the [redacted] tax shelters. We have discussed the issues raised by these cases with Ms. Diane Berkowitz of your office in telephone conversations and in meetings held in the National Office on December 12-13, 1988. We set forth in this memorandum our response to the issues identified in your request and indicate areas raised in the December meetings that will be discussed in a supplemental memorandum to be provided in the near future.

## ISSUES

1. Whether the promissory notes signed by the partners investing in the [redacted] shelters have economic substance, entitling the partners to accrue for tax purposes the noncash portion of the cost of the intangible drilling and development costs.

2. Whether the turnkey drilling contracts executed by the partnerships are representative of legitimate turnkey contracts.

3. Whether the proposed settlement of the partnership's treatment of the promissory notes, which would result in a decrease in the partners' share of the liabilities, would be considered as a distribution of money entitled to capital gains treatment by the partners.

## FACTS 1/

In [redacted], petitioner [redacted] formed the [redacted] general partnerships, [redacted],

1/ The statement of facts is based on the documents and information provided to us by Ms. Diane Berkowitz of your office.

having the stated purpose of engaging in an oil drilling program in [redacted] and [redacted]. The plan called for the partnerships to enter into turnkey contracts for the drilling of a specified number of development wells ([redacted] for [redacted] and [redacted] for [redacted]) down to the Granville Sand or to a depth of 1000 feet, whichever was reached first. Each partnership entered into an agreement with [redacted] on [redacted], to acquire [redacted] percent of the working interest in certain oil and gas leases in [redacted] and [redacted].

Petitioner sold "units" in the partnerships by private placement to individual investors. Each investor tendered (1) cash for approximately [redacted] percent and (2) a promissory note to the partnership for the remainder of the purchase price. Each partnership, in turn, entered into turnkey contracts with [redacted] on [redacted]. Under the turnkey contracts, [redacted] agreed to provide "any and all necessary services and supplies for drilling" the specified number of development wells and, if necessary, to bring each well "to the production of oil into the tanks," excluding necessary capital equipment and other tangible costs required for production. The contracts required that the drilling of the specified number of development wells be performed no later than [redacted]. Although the contracts made [redacted] responsible for providing "all labor and drilling for installation of tertiary injection wells," they do not include specific details or requirements for a tertiary injection program.

As required under the turnkey contracts, each partnership paid [redacted] in advance at the rate of $[redacted] per development well. Those payments were in the form of [redacted] percent cash and a [redacted]-year "full recourse promissory note" for the remaining [redacted] percent. The notes carried an annual interest rate of [redacted] percent and called for monthly payments beginning the [redacted] month following the receipt of production income. The monthly payments were set at [redacted] percent of any monthly production income less maintenance expenses chargeable to producing wells. Under the terms of the notes, any unpaid principal became due at the end of [redacted] years. 2/

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2/ The [redacted] partnerships involved in this case and related cases are apparently similar in form and operation to partnerships established and promoted by [redacted]. The docketed cases related to the various [redacted] partnerships are coordinated under the [redacted]. In the [redacted] partnerships, [redacted] is the managing partner. In contrast, petitioner is the managing partner in the [redacted] partnerships, and [redacted] has no equity

The evidence indicates that the specified number of wells were drilled prior to [redacted], but none yielded commercially producible quantities of oil or gas. All of the wells drilled for the partnerships were plugged and abandoned pursuant to state law in [redacted]. Petitioner contends that one or more injections wells were drilled but has not provided evidence of any such wells. It appears that crude oil with a value of approximately $[redacted] was produced by the [redacted] partnerships. There is no record, however, of any payments on the promissory notes to [redacted] or of any payments on the investors' individual notes to the partnerships.

DISCUSSION

Issue 1: Promissory Notes

The promissory notes given by the partnerships to [redacted] call for monthly payments equal to [redacted] percent of the net revenues from production until full payment of the principal. The notes given by the investors to the partnerships contain similar provision for monthly payments from [redacted] percent of the investor's percentage participation in the net revenues. The investors' notes were secured only by their respective interests in the Annuities partnerships. If the notes contained no other provisions, they would be nonrecourse and would raise issues of economic substance similar to the issues addressed in Gibson Products Co. v. United States, 460 F. Supp. 1109 (N.D. Tex. 1978), aff'd on other grounds, 637 F.2d 1041 (5th Cir. 1981), and Brountas v. Commissioner, 73 T.C. 491 (1979), vacated on other grounds, 692 F.2d 152 (1st Cir. 1982), cert. denied, 462 U.S. 1106 (1983).

Both sets of notes, however, require payment of any unpaid principal and interest at the end of [redacted] years. Thus, even if there is no production from which to make loan payments, the makers of the notes are liable at the end of [redacted] years for the entire face amount of the notes plus interest at the rate of [redacted] percent per annum. Because of this additional provision, the notes represent full recourse liabilities by the partnerships and their partners. Accordingly, even though it appears that no payments have been made on the notes as a result of production, we believe that the Tax Court would find that the notes have economic substance.

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participation. For that reason and because the issues are not identical, the cases related to the [redacted] partnerships are not coordinated within the [redacted].

We believe, however, that the inquiry does not end with the conclusion that the notes have economic substance. In our view, the total amounts of the payments under the turnkey contracts do not represent reasonable intangible drilling and development costs ("IDC") and are not deductible in full as such for tax year [redacted]. During the December meeting at the National Office, an issue was raised concerning whether the opinion in Stradlings Building Materials, Inc. v. Commissioner, 76 T.C. 84 (1981), precludes the denial of a deduction for the portion of the payment represented by the promissory notes. We are currently analyzing this question and will discuss it in a supplemental memorandum in the near future.

Issue 2: Turnkey Contracts

Your request asks whether the turnkey drilling contracts at issue in these cases are legitimate turnkey contracts.

Our review indicates that the contracts are not "standard" turnkey drilling contracts in the sense that they follow the identical format and structure of representative industry contracts prepared by the American Petroleum Institute. On the other hand, the contracts between the partnerships and [redacted] contain many of the provisions that typically appear in such turnkey contracts. In particular, they set forth specific terms regarding the number of development wells to be drilled, the required depth of drilling, and an enumeration of the driller's responsibilities in return for the fixed price. In that sense, we believe that the contracts are legitimate and are not subject to attack for lack of economic substance, particularly in light of the evidence that most, if not all, the specified number of development wells were actually drilled.

We note that the provision concerning the drilling of tertiary injection wells lacks specificity and does not set forth any details with respect to the number of such wells to be drilled or even whether injection wells would be drilled. Because of the vagueness of this provision, we believe that any IDC associated with the drilling of injection wells was contingent and not deductible at the time the contract was executed. We will discuss this more fully in the supplemental memorandum concerning the IDC deduction.

Issue 3: Treatment of Decrease in Partnership Liabilities

This issue involves petitioner's proposed settlement under which the partnerships would recognize income in [redacted] equal to the amount of the promissory notes as a result of the decision in that year to abandon the drilling programs. Your request asked whether the partners would be entitled to treat their percentage share of that income as a distribution entitled to capital gains based upon the Fifth Circuit's opinion in Stackhouse v. United States, 441 F.2d 465 (5th Cir. 1971). We coordinated our response to this issue with Branch No. 1 of Tax Litigation Division and attach a copy of the memorandum prepared by Branch No. 1 concluding that the Stackhouse opinion is not applicable and that the partners would not be entitled to capital gains treatment.

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As indicated above, we will forward in the near future a supplemental memorandum regarding further analysis of the reasonableness of the IDC deduction. In the interim, please contact Gerald Fleming at FTS 566-3345 if you have any questions concerning this matter.

MARLENE GROSS
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(Tax Litigation)

By: Patrick Putzi
PATRICK PUTZI
Special Litigation Counsel
(Natural Resources)

Attachment:
As stated.